

## Part III - Administrative, Procedural, and Miscellaneous

This notice clarifies and modifies certain provisions of the temporary and proposed regulations under section 482 of the Code relating to controlled services transactions, and section 6662 of the Code relating to transfer pricing documentation penalties.

Notice 2007-5

### SECTION 1. PURPOSE

On August 4, 2006, the Treasury Department and the IRS published T.D. 9278, containing temporary and proposed regulations that address controlled services under section 482 (71 Fed. Reg. 44466). This notice makes several clarifications concerning provisions in the temporary and proposed regulations, primarily relating to the services cost method. In addition, this notice makes certain modifications to the effective date of the temporary regulations.

### SECTION 2. BACKGROUND

The temporary and proposed regulations provided for a new transfer pricing method applicable to certain controlled services transactions, the services cost method (SCM). Under specified circumstances, the SCM allows the arm's length charge for a controlled services transaction to be determined by reference to total services costs, without a markup. Two categories of covered services are potentially eligible for this method, specified covered services and low margin covered services, both defined in Temp. Treas. Reg. § 1.482-9T(b)(4). To demonstrate that a particular controlled service

qualifies for the SCM, the taxpayer must reasonably conclude, in its business judgment, that the service does not contribute significantly to key competitive advantages, core capabilities, or fundamental risks of success or failure in one or more trades or businesses of the renderer, the recipient, or both. Temp. Treas. Reg. § 1.482-9T(b)(2) (business judgment rule). Specified covered services are those controlled services that the Commissioner identifies by means of a revenue procedure. Low-margin covered services are controlled services transactions for which the arm's length mark-up, determined by reference to comparable uncontrolled transactions, equals 7% or less.

The Treasury Department and the IRS issued a proposed revenue procedure that identified specified covered services. See Announcement 2006-50, 2006-34 I.R.B. 321 (August 21, 2006). That proposed revenue procedure identified forty-eight activities or groups of activities that constitute specified covered services. Contemporaneously with the issuance of this notice, the IRS intends to issue a final revenue procedure on this topic before December 31, 2006. The revenue procedure may be further updated, as appropriate, including in connection with the conclusion of the one-year transition period provided by this notice and in the course of finalization of the temporary regulations in response to comments.

The temporary and proposed regulations also added a provision in Temp. Treas. Reg. § 1.482-9T(b)(5) concerning shared services arrangements (SSAs). Provided that the taxpayer satisfies the conditions for use of an SSA, which includes reasonably concluding that the SSA utilizes the most reliable measure of the participants' respective shares of the reasonably anticipated benefits from the covered services, the

IRS will not make an adjustment to the taxpayer's allocation. An SSA must be structured such that: (1) it includes two or more participants; (2) each participant reasonably anticipates a benefit from one or more covered services specified in the SSA; and (3) each covered service confers a benefit on at least one participant in the SSA. See Temp. Treas. Reg. § 1.482-9T(b)(5). Services eligible to be included in an SSA are limited to services that qualify for the SCM. Temp. Treas. Reg. § 1.482-9T(b)(5)(i).

The temporary and proposed regulations are generally effective for taxable years that begin after December 31, 2006. Temp. Treas. Reg. § 1.482-9T(n). A taxpayer may elect to apply the temporary regulations to open tax years that begin after September 10, 2003.

### SECTION 3. CLARIFICATIONS, PARTIAL MODIFICATION OF EFFECTIVE DATE

Numerous public comments were submitted concerning both Announcement 2006-50 and the temporary and proposed regulations. In response to these comments, this notice describes modifications to the list of specified covered services, as adopted in the final revenue procedure. The notice also modifies the effective date of the temporary regulations in several respects, as described below. Lastly, the notice makes several clarifications concerning the intended application of the regulations, as described below. These clarifications will be considered during the process of finalizing the temporary regulations. In the interim, and pending the issuance of final regulations under Treas. Reg. § 1.482-9, and other related provisions, taxpayers may rely on the guidance contained in this notice.

### §3.01 Partial Modification of Effective Date -- SCM Provisions

The temporary and proposed regulations are effective for tax years beginning after December 31, 2006 (with retroactive application for tax years beginning after September 10, 2003, at the election of the taxpayer). See Temp. Treas. Reg. § 1.482-9T(n). Several commentators requested that the effective date of the entire regulations be moved back one year, which in their view would provide taxpayers sufficient time to modify accounting systems and to take other steps, including preparation of contractual agreements and other transfer pricing documentation, deemed necessary to comply fully with the temporary regulations.

In response to these comments, this notice partially modifies the effective date of Temp. Treas. Reg. § 1.482-9T(b) of the temporary regulations. Subject to the exceptions described below, the effective date of the temporary regulations, as they pertain to the identification of controlled services eligible to be priced at cost, is moved back one year. The temporary regulations will thus apply to taxable years after December 31, 2007, for all provisions related to the SCM in Temp. Treas. Reg. § 1.482-9T(b). The only SCM provision that has immediate effect, i.e., for taxable years beginning after December 31, 2006, is the business judgment rule in Temp. Treas. Reg. § 1.482-9T(b)(2).

The net effect of this modification is that, for taxable years with beginning dates from January 1, 2007 to December 31, 2007, taxpayers may apply the existing regulations in Treas. Reg. § 1.482-2(b) for purposes of identifying controlled services that are eligible to be priced on a cost basis, without a markup. For such taxable years,

services that are priced on a cost basis must be “non-integral” within the meaning of existing Treas. Reg. § 1.482-2(b)(7), and they must also satisfy the SCM business judgment test in Temp. Treas. Reg. § 1.482-9T(b)(2). Other SCM related provisions, including the documentation provision in Temp. Treas. Reg. § 1.482-9T(b)(3)(i) and the excluded transactions in Temp. Treas. Reg. § 1.482-9T(b)(3)(ii), are inapplicable to transactions during this one-year period. Consequently, in this context, the existing documentation standards applicable to controlled services will apply to transactions during this one-year period. Alternatively, for tax years beginning between January 1, 2007 and December 31, 2007, taxpayers may elect to apply the SCM as set forth in Temp. Treas. Reg. § 1.482-9T(b), without taking into account any of the modifications described above.

The provisions of Temp. Treas. Reg. § 1.482-9T(b) will be effective in all respects for taxable years beginning after December 31, 2007.

### §3.02 Services Cost Method Applies Only at Option of Taxpayer

Several commentators requested confirmation that application of the SCM was a matter within the control of the taxpayer, assuming that the underlying transactions qualified for the SCM. Commentators observed that the temporary regulations could be interpreted as requiring a taxpayer to apply the SCM, if all the conditions for that method were satisfied. In the view of commentators, this would conflict with the ability of a taxpayer to apply the best method rule, including by applying a transfer pricing method

other than the SCM.

This notice confirms that under the temporary regulations the SCM is elective by taxpayers. A statement in its books and records evidencing the taxpayer's intent to apply the SCM is required as a necessary condition to applicability of the SCM. Temp. Treas. Reg. § 1.482-9T(b)(3)(i)(second sentence). This notice also confirms that there is no requirement for a taxpayer to attach such statement to its tax return, as typically is the case with elections that are to be flagged to the IRS' attention.

### §3.03 Listing of Specified Covered Services in Announcement 2006-50

Several commentators contended that the proposed list of specified covered services in Announcement 2006-50 was too narrow to be of practical use. Some commentators suggested that the list should refer to departments or to accounting classifications, rather than to specific activities or groups of activities. One commentator suggested that all activities in particular departments should be identified as eligible for the SCM. Other commentators supported the general approach taken in Announcement 2006-50, but suggested that the list include certain additional activities, so as to describe the back office in a more comprehensive manner.

The SCM is intended to provide a practical and administrable means of identifying low-margin services that may be evaluated by reference to total services cost without a markup. The SSA provision affords taxpayers the flexibility to analyze specified covered services and low margin covered services that produce benefits to multiple recipients, under a joint-benefit approach. Flexible grouping rules are adopted for purposes of the SCM and the SSA provisions. Temp. Treas. Reg. § 1.482-

9T(b)(4)(first sentence parenthetical) and (b)(5)(iii)(B). In the view of the Treasury Department and the IRS, these provisions afford flexibility to analyze covered services in a way that does not impose inappropriate compliance burdens. Accordingly, the Treasury Department and the IRS decline to adopt a departmental approach to identification of specified covered services eligible for the SCM.

In response to public comments, however, the Treasury Department and the IRS have concluded that certain modifications to the list of specified covered services in Announcement 2006-50 are appropriate. Several further categories will be added, and further activities will be specified within the categories. In addition, the individual categories of specified covered services will also include “other similar activities.” This reflects the conclusion of the Treasury Department and the IRS that the list of specified covered services should be structured and interpreted in a practical, common-sense manner. The changes described in this paragraph are reflected in Rev. Proc. 2007-13, which is published contemporaneously with this Notice.

#### §3.04 Business Judgment Rule

In finalizing the regulations, the Treasury Department and the IRS will incorporate provisions consistent with the following interpretations of the business judgment rule.

##### (1) Applies by Reference to Controlled Group

In evaluating whether a controlled services transaction qualifies for the SCM, the

temporary regulations provide that the business judgment rule should be applied by reference to “one or more trades or businesses of the renderer, recipient, or both.”

Temp. Treas. Reg. § 1.482-9T(b)(2) (emphasis added). Commentators observed that this rule may yield incorrect results in some cases, for example, where a dedicated services subsidiary performs primarily low margin covered services or specified covered services, and few other activities. The activities performed by such an entity would potentially be ineligible for the SCM under the business judgment rule, because they would constitute the entity’s core capability.

This notice provides that taxpayers are to apply the business judgment rule by reference to one or more trades or businesses of the controlled group, as defined in Treas. Reg. § 1.482-1(i)(6), instead of “the renderer, recipient, or both,” as stated in Temp. Treas. Reg. § 1.482-9T(b)(2).

#### (2) Evaluates Contributions to Operating Profit

This notice provides that the business judgment rule in Temp. Treas. Reg. § 1.482-9T(b)(2) should take into account whether a particular activity contributes to the operating profit of one or more controlled parties, as that term is defined in Treas. Reg. § 1.482-5(d)(3). For example, the activities performed by a corporate tax department should not be disqualified from the SCM, given that these activities primarily affect foreign income taxes (as defined in § 1.901-2(a)) and domestic income taxes, which are not classified as operating expenses. See Treas. Reg. § 1.482-5(d)(3).

#### (3) Taxpayer’s Reasonable Business Judgment

Several commentators expressed concern over how the business judgment rule



would be administered. They raised questions concerning how to evidence the necessary business judgment, for example, whether an executive's representation must be preferred to the tax director's. Commentators also requested that statements from the preamble to the temporary regulations be incorporated in final regulations.

The Treasury Department and the IRS reiterate that the temporary regulations already incorporate a high threshold for application of the business judgment rule to exclude services otherwise eligible for the SCM. The exclusion is inapplicable so long as the taxpayer reasonably concludes in its business judgment that the covered services do not contribute significantly to key competitive advantages, core capabilities, or fundamental risks of success or failure in one or more trades or businesses of the controlled group.

The test is satisfied by a reasonable exercise of the taxpayer's business judgment, not a reasonable exercise of the IRS's judgment in examining the taxpayer. In the view of the Treasury Department and the IRS, the gloss in the preamble to the temporary regulations, such as that this is a business judgment preeminently within the business person's own expertise, flows directly from the regulations' specification that the matter lies in the taxpayer's reasonable business judgment. The evidence necessary to establish the taxpayer's reasonable business judgment is determined under all the facts and circumstances. No source, executive or otherwise, is generally more probative than another.

#### §3.05 Shared Services Concept Applicable to non-SCM Services

In general, commentators supported the SSA provision as a useful mechanism

for allocation of costs from shared or centralized services. Commentators called into question, however, the need to restrict SSAs to covered services eligible to be analyzed under the SCM. In the view of the commentators, extending the SSA concept to all controlled services would produce accurate results and would also be consistent with the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, in particular, the provisions pertaining to cost contribution arrangements.

This Notice confirms that taxpayers may also make allocations of arm's length charges for services ineligible for the SCM that yield a benefit to multiple members of a controlled group. In such a case, however, the flexible rules under the SCM for establishing the joint benefits and selecting the allocation key are inapplicable. Instead, the more robust analysis under the general transfer pricing rules applies for purposes of determining the appropriate arm's length charges, benefits, allocation keys, etc.

#### §3.06 Documentation Provisions

This notice clarifies that the documentation for services analyzed under the SCM, described in Temp. Treas. § 1.482-9T(b)(3)(i) (adequate books and records) need not be generated contemporaneously with the filing of the income tax return.

In addition, for tax years beginning after December 31, 2006, and on or before December 31, 2007, the written contract specified by Temp. Treas. Reg. § 1.482-9T(i)(2) need not be entered into prior to, or contemporaneous with the start of the activity or group of activities. Instead, the written contract need only be prepared prior to, or contemporaneous with the filing of the income tax return.

### §3.07 Penalty Relief for Certain Controlled Services Transactions

During a one-year transition period, the Treasury Department and the IRS intend that taxpayers' reasonable efforts to comply with the temporary regulations, as modified by this notice, will avoid the imposition of penalties for controlled services transactions, except for those evaluated under Treas. Reg. § 1.482-2(b), as modified by section 3.01 of this notice.

Accordingly, this notice provides that penalties, including but not limited to penalties within the meaning of section 6662(e) and (h) of the Code, will not apply to controlled services transactions (except for those evaluated under Treas. Reg. § 1.482-2(b)(3), as modified by section 3.01 of this notice), for taxable years beginning after December 31, 2006 and on or before December 31, 2007, provided that the taxpayer makes reasonable efforts to comply with documentation provisions in I.R.C. § 6001 and Treas. Reg. § 1.6662-6(d)(2)(iii).

In determining whether a taxpayer's efforts are reasonable, the Service will take into consideration that a taxpayer may not yet have all of its intercompany agreements in place and may be implementing changes to its accounting systems during this one-year transition period. If, however, the taxpayer fails to provide the Service with any transfer pricing documentation in connection with its controlled services transactions within the applicable time period, such actions will be deemed unreasonable.

This relief from penalties is intended to provide a reasonable transition period during which taxpayers may analyze the temporary and proposed regulations, execute any required contractual agreements, and prepare transfer pricing documentation for

transactions subject to the regulations. This clarification does not limit the ability of the Commissioner to make section 482 allocations with respect to charges for services transactions that take place during this period or to apply penalties to controlled services transactions that are evaluated under Treas. Reg. § 1.482-2(b), as modified by section 3.01 of this notice.

#### SECTION 4. REQUEST FOR COMMENTS

The Treasury Department and the IRS request further comments from interested persons on the rules announced in this notice. In addition, the revenue procedure issued contemporaneously with this notice is intended to be an evolving list of services that are eligible for the SCM. The Treasury Department and the IRS contemplate issuing updates as appropriate, including a further revision of the revenue procedure to coincide with the end of the one-year transition period and in response to comments received on the temporary regulations. Comments are solicited on the categories and listed activities in the revenue procedure, possible additions, and other revisions. For example, comments are solicited whether warehousing and other functions that support distribution should be eligible for the SCM in light of Temp. Treas. Reg. § 1.482-9T(b)(3)(ii)(E)(reselling, distribution ineligible for SCM).

Written comments may be submitted to CC:INTL:6 (Notice 2007-5), room 4607, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20224. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:INTL:6 (Notice 2007-5) Courier's desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224. Alternatively,

taxpayers may submit comments electronically via the following e-mail address:

[Notice.Comments@irscounsel.treas.gov](mailto:Notice.Comments@irscounsel.treas.gov). Please include "Notice 2007-5" in the subject line of any electronic communications.

#### SECTION 5. DRAFTING INFORMATION

The principal authors of this notice are Thomas A. Vidano and Carol B. Tan of the Office of Associate Chief Counsel (International). For further information regarding this notice contact Thomas A. Vidano or Carol B. Tan at (202) 622-5265 (not a toll-free call).